

(v) For 2000, M must include in gross income the amount relating to gas sales of 460 mmcf, that is, the amount of M's own gas sales of 40 mmcf and the amount of the payment received from L for the 420 mmcf of M's gas that L sold (consisting of 300 mmcf in 1997, 60 mmcf in 1998, and 60 mmcf in 1999). Under paragraph (d)(3)(iii)(A) of this section, M computes a depletion deduction and a production credit relating to the amount of M's actual gas sales for 2000 and the payment received from L, that is, relating to a total of 460 mmcf of gas (M's sales of 40 mmcf for 2000, plus L's payment for 420 mmcf of gas). Under paragraph (d)(3)(ii)(B) of this section, L's deduction for making its payment to M for 420 mmcf of gas is allowable only for 2000. Under paragraph (d)(3)(iii)(B) of this section, L must reduce its deduction by the amount of any percentage depletion deductions allowed on its sales of M's gas, that is, relating to 360 mmcf of gas (300 mmcf for 1997 and 60 mmcf for 1998). In addition, under paragraph (d)(3)(iii)(C) of this section, L must increase its tax for 2000 by the amount of any section 29 credit L claimed on its sales of M's gas, but only to the extent that the credit claimed actually reduced L's tax in any earlier year.

Example 3. Non-abusive altering of the taking of production for a taxable year. (i) C and D enter into a JOA and a GBA on December 1, 1994, for gas production from a reservoir. The JOA allocates production at 50 percent to C and 50 percent to D. C and D agree in writing to use the cumulative method to account for gas sales. Additionally, C and D elect under section 761(a) and this section to exclude their organization from the application of subchapter K. C and D arrange to sell all their production under annually renewable contracts. In 1995, C and D each sell 480 mmcf of gas from the reservoir.

(ii) In November 1995, D is notified that its contract with its purchaser will not be renewed for 1996. D is unable to find a new purchaser for its gas for 1996. In December 1995, D notifies C that it will not be taking production from the reservoir in 1996. Pursuant to the GBA, C then contracts with its current gas purchaser to sell an additional 20 mmcf per month in 1996. Accordingly, C sells 720 mmcf in 1996 (60 mmcf per month \times 12 months). Under the facts described in this example, a principal purpose of altering the taking of production is not to avoid tax. Accordingly, the co-producers' election under section 761(a) will not be revoked by reason of altering the taking of production.

Example 4. Abusive altering of the taking of production for a taxable year. The facts are the same as in *Example 3*(i). For 1996, C anticipates that C's regular tax (reduced by the credits allowable under sections 27 and 28) will not exceed C's tentative minimum tax. Accordingly, under section 29(b)(6), C's credit allowed under section 29(a) for sales of its

gas will be zero. For 1997, C anticipates that its credit allowed under section 29(a) will not be limited by section 29(b)(6). On the other hand, D anticipates that any credit it may claim under section 29(a) for 1996, even including a credit based on sales of C's share of current production under the JOA, will not be limited by section 29(b)(6). However, for 1997, D anticipates that its credit under section 29(a) will be limited by section 29(b)(6). On January 1, 1996, C and D agree that D will contract with its purchaser to sell the entire 960 mmcf produced from the reservoir in 1996 and that C will contract with its purchaser to sell the entire 960 mmcf produced from the reservoir in 1997. Under these facts, a principal purpose of altering the taking of production is to avoid tax. Accordingly, the co-producers' election under section 761(a) will be revoked for 1996 and for subsequent years.

(7) *Effective date.* Except in the case of a part-year change to the annual method or the cessation of a JOA, both of which are described in paragraph (d)(2)(ii)(C) of this section, the provisions of this paragraph (d) apply to all taxable years beginning after December 31, 1994, of any producer that is a member of an unincorporated organization that produces natural gas under a JOA in effect on or after the start of the producer's first taxable year beginning after December 31, 1994. In the case of a part-year change, the provisions of this paragraph (d) apply on and after January 1, 1996. In the case of the cessation of a JOA, the co-producers use their current method of accounting with respect to that JOA until the JOA ceases to be in effect.

(e) *Cross reference.* For requirements with respect to the filing of a return on Form 1065 by a partnership, see § 1.6031-1.

[T.D. 7208, 37 FR 20687, Oct. 3, 1972; 37 FR 23161, Oct. 31, 1972, as amended by T.D. 8578, 59 FR 66183, Dec. 23, 1994; 60 FR 11028, Mar. 1, 1995]

§ 1.761-3 Certain option holders treated as partners.

(a) *Noncompensatory option treated as a partnership interest—*(1) *General rule.* A noncompensatory option (as defined in paragraph (b)(2) of this section) is treated as a partnership interest for all Federal tax purposes if, on the date of a measurement event (as defined in paragraph (c) of this section) with respect to the option—

(i) The noncompensatory option (and any agreements associated with it) provides the option holder with rights that are substantially similar to the rights afforded a partner (as determined under paragraph (d) of this section); and

(ii) There is a strong likelihood that the failure to treat the holder of the noncompensatory option as a partner would result in a substantial reduction in the present value of the partners' and noncompensatory option holder's aggregate Federal tax liabilities (as determined under paragraph (e) of this section).

(2) *Continuing applicability of general principles of law.* The fact that an option is not treated as a partnership interest under this section does not prevent the option from being treated as a partnership interest under general principles of Federal tax law.

(3) *Timing of characterization.* If a noncompensatory option is treated under this section as a partnership interest, that treatment applies, as the case may be, upon the issuance of the option, or immediately before any other measurement event that gave rise to the characterization under paragraph (a)(1) of this section.

(4) *Effect of characterization.* If a noncompensatory option is treated as a partnership interest under this section or under general principles of law, the option holder will be treated as a partner with respect to the partnership interest and will receive a distributive share of the partnership's income, gain, loss, deduction, or credit (or items thereof), as determined in accordance with that partner's interest in the partnership (taking into account all facts and circumstances) in accordance with § 1.704-1(b)(3). Once a noncompensatory option is treated as a partnership interest, in no event may it be characterized as an option thereafter.

(b) *Definitions.* For purposes of this section:

(1) *Look-through entity.* *Look-through entity* means an entity described in § 1.704-1(b)(2)(iii)(d)(2).

(2) *Noncompensatory option.* *Noncompensatory option* means an option (as defined in paragraph (b)(3) of this section) issued by a partnership, other than an option issued in connection

with the performance of services. For purposes of applying this section, an option that would be a noncompensatory option under this paragraph if it had been issued by a partnership is a noncompensatory option if the option was issued by an eligible entity (as defined in § 301.7701-3(a)) that would become a partnership under § 301.7701-3(f)(2) if the noncompensatory option holder were treated as a partner. Also for purposes of applying this section, if a noncompensatory option is issued by such an eligible entity, then the eligible entity is treated as a partnership.

(3) *Option.* An *option* is a contractual right to acquire an interest in the issuing partnership, including a call option, warrant, or other similar arrangement. In addition, an option includes convertible debt (as defined in § 1.721-2(g)(2)) and convertible equity (as defined in § 1.721-2(g)(3)). To achieve the purposes of this section, the Commissioner can treat other contractual agreements, including a forward contract, a futures contract, or a notional principal contract, as an option. A contract that otherwise constitutes an option will not fail to be treated as an option for purposes of this section merely because it may or must be settled in cash or property other than a partnership interest.

(4) *Underlying partnership interest.* *Underlying partnership interest* means the interest in the issuing partnership that would be acquired by the noncompensatory option holder upon exercise of the noncompensatory option.

(c) *Measurement event*—(1) *General rule.* Except as provided in paragraph (c)(2) of this section, a measurement event with respect to a noncompensatory option is any of the following events:

(i) Issuance of the noncompensatory option;

(ii) An adjustment of the terms (modification) of the noncompensatory option or of the underlying partnership interest (as defined in paragraph (b)(4) of this section) (including an adjustment pursuant to the terms of the noncompensatory option or the underlying partnership interest);

(iii) Transfer of the noncompensatory option if either:

(A) The option may be exercised (or settled) more than 12 months after its issuance, or

(B) The transfer is pursuant to a plan in existence at the time of the issuance or modification of the noncompensatory option that has as a principal purpose the substantial reduction of the present value of the aggregate Federal tax liabilities of the partners and the noncompensatory option holder (under paragraph (a)(1)(ii) of this section);

(2) *Events not treated as measurement events.* A measurement event does not include the following events:

(i) A transfer of the noncompensatory option at death, between spouses or former spouses under section 1041, or in a transaction that is disregarded for Federal tax purposes;

(ii) A modification that neither materially increases the likelihood that the noncompensatory option will be exercised (as described in paragraph (d)(2) of this section) nor provides the noncompensatory option holder with partner attributes (as described in paragraph (d)(3) of this section);

(iii) A change in the strike price of a noncompensatory option or in the interests in the issuing partnership that may be issued or transferred pursuant to the noncompensatory option, made pursuant to a bona fide, reasonable adjustment formula that has the intended effect of preventing dilution of the interests of the noncompensatory option holder;

(iv) Any other event as provided in guidance published in the Internal Revenue Bulletin.

(d) *Rights substantially similar to partner rights—(1) In general.* A noncompensatory option provides the holder with rights that are substantially similar to the rights afforded to a partner if either the option is reasonably certain to be exercised or the option holder possesses partner attributes.

(2) *Reasonable certainty of exercise—(i) General rule.* The determination of whether a noncompensatory option is reasonably certain to be exercised at the time of a measurement event is based on all the facts and circumstances, including—

(A) The fair market value of the partnership interest that is the subject of the noncompensatory option;

(B) The strike price of the noncompensatory option;

(C) The term of the noncompensatory option;

(D) The volatility of the value or income of the issuing partnership or the underlying partnership interest;

(E) Anticipated distributions by the partnership during the term of the noncompensatory option;

(F) Any other special option features, such as a strike price that fluctuates;

(G) The existence of related options, including reciprocal options; and

(H) Any other arrangements affecting or undertaken with a principal purpose of affecting the likelihood that the noncompensatory option will be exercised.

(ii) *Safe harbors—(A) General rule.* Except as provided in paragraph (d)(2)(ii)(C) of this section, a noncompensatory option is not considered reasonably certain to be exercised if, as of the date of a measurement event with respect to the noncompensatory option—

(1) The option may be exercised no more than 24 months after the date of the measurement event and the strike price is equal to or greater than 110 percent of the fair market value of the underlying partnership interest on the date of the measurement event; or

(2) The terms of the option provide that the strike price of the option is equal to or greater than the fair market value of the underlying partnership interest on the exercise date.

(B) *Options exercisable at fair market value.* For purposes of paragraph (d)(2)(ii)(A) of this section, an option whose strike price is determined by a formula is considered to have a strike price equal to or greater than the fair market value of the underlying partnership interest on the exercise date if the formula is agreed upon by the parties when the option is issued in a bona fide attempt to arrive at the fair market value on the exercise date and is to be applied based on the facts and circumstances in existence on the exercise date.

(C) *Exception.* The safe harbors of paragraph (d)(2)(ii)(A) of this section

do not apply if the parties to the noncompensatory option had a principal purpose described in paragraph (c)(1)(iii)(B) of this section with respect to a measurement event for that option (or, if multiple options were issued pursuant to a plan, a measurement event with respect to any option issued pursuant to that plan).

(D) *Failure to satisfy safe harbor.* Failure of an option to satisfy one of the safe harbors of paragraph (d)(2)(ii)(A) does not affect the determination of whether an option is treated as reasonably certain to be exercised.

(3) *Partner attributes*—(i) *General rule.* The determination of whether a holder of a noncompensatory option possesses partner attributes is based on all the facts and circumstances, including whether the option holder, directly or indirectly, through the option agreement or a related agreement, is provided with voting rights or managerial rights in the partnership.

(ii) *Certain factors that conclusively establish partner attributes.* For purposes of this section, a noncompensatory option holder has partner attributes if, based on all the facts and circumstances—

(A) The option holder is provided with rights (through the option agreement or a related agreement) that are similar to rights ordinarily afforded to a partner to participate in partnership profits through present possessory rights to share in current operating or liquidating distributions with respect to the underlying partnership interests; or

(B) The option holder, directly or indirectly, undertakes obligations (through the option agreement or a related agreement) that are similar to obligations undertaken by a partner to bear partnership losses.

(iii) *Special rules.* The following rules apply for purposes of paragraphs (d)(3)(i) and (d)(3)(ii) of this section:

(A) Rights in the issuing partnership possessed by a noncompensatory option holder solely by virtue of owning an interest in the issuing partnership are not taken into account, provided that those rights are no greater than the rights granted to other partners owning substantially similar interests in the partnership and who do not hold

noncompensatory options in the partnership.

(B) If all of the partners owning substantially similar interests in the issuing partnership also hold noncompensatory options in the partnership, or if none of the other partners owns substantially similar interests in the partnership, then all facts and circumstances will be considered in determining whether the rights in the partnership possessed by the option holder are possessed solely by virtue of owning a partnership interest. If those rights are possessed solely by virtue of owning a partnership interest, they are not taken into account.

(C) A noncompensatory option holder will not ordinarily be considered to possess partner attributes solely because the noncompensatory option agreement significantly controls or restricts, or the noncompensatory option holder has the ability to significantly control or restrict, a partnership decision that could substantially affect the value of the underlying partnership interest. In particular, the following abilities of the option holder will not be treated as partner attributes:

(1) The ability to impose reasonable restrictions on partnership distributions or dilutive issuances of partnership equity or options while the noncompensatory option is outstanding.

(2) The ability to choose the partnership's section 704(c) method for partnership properties.

(D) When the applicable measurement event is a transfer described in paragraph (c)(1) of this section, the partner attributes of the transferee, not the transferor, are taken into account.

(E) The option holder will be treated as owning all partnership interests and noncompensatory options issued by the partnership that are owned by any person related to the option holder. For purposes of the preceding sentence, a person related to the option holder is defined as any person bearing a relationship to the option holder described in section 267(b) or 707(b).

(e) *Substantial tax reduction requirement*—(1) *General rule.* The determination of whether there is a strong likelihood that the failure to treat a noncompensatory option holder as a partner would result in a substantial reduction in the present value of the partners' and the noncompensatory option holder's aggregate Federal tax liabilities is based on all the facts and circumstances, including—

(i) The interaction of the allocations of the issuing partnership and the partners' and noncompensatory option holder's Federal tax attributes (taking into account tax consequences that result from the interaction of the allocations with the partners' and noncompensatory option holder's Federal tax attributes that are unrelated to the partnership);

(ii) The absolute amount of the Federal tax reduction;

(iii) The amount of the reduction relative to overall Federal tax liability; and

(iv) The timing of items of income and deductions.

(2) *Special rules.* For purposes of applying paragraph (e)(1) of this section to a partner or noncompensatory option holder that is—

(i) A look-through entity (as defined in paragraph (b)(1) of this section), the Federal tax consequences that result from the interaction of allocations of the partnership and the Federal tax attributes of any person that is an owner, or in the case of a trust or estate, the beneficiary, of an interest in such a partner or noncompensatory option holder, whether directly, or indirectly through one or more look-through entities, must be taken into account; or

(ii) A member of a consolidated group (within the meaning of § 1.1502-1(h)), the tax consequences that result from the interaction of the issuing partnership's allocations and the tax attributes of the consolidated group and the tax attributes of another member with respect to a separate return year must be taken into account.

(f) *Example.* The following example illustrates the provisions of this section. For purposes of the example, assume that PRS is a partnership for Federal tax purposes, none of the noncompensatory option holders or partners are

related persons, and that general principles of law do not apply to treat the noncompensatory option as a partnership interest. The example reads as follows:

Example. Active trade or business. PRS is engaged in an active real estate business, the amount of income, gain, loss, and deductions from which cannot be predicted with any reasonable certainty. In exchange for a premium of \$10x, PRS issues a noncompensatory option to A to acquire a 10 percent interest in PRS for \$110x at any time during a 3-year period commencing on the date on which the option is issued. At the time of the issuance of the noncompensatory option, a 10 percent interest in PRS has a fair market value of \$100x. Due to the nature of PRS's business, the value of a 10 percent PRS interest in 3 years is not reasonably predictable as of the time the noncompensatory option is issued. Assuming there are no other facts affecting the certainty of the option's exercise, it is not reasonably certain that A's option will be exercised. Therefore, assuming that A does not possess partner attributes as described in paragraph (d)(3) of this section, A's noncompensatory option is not treated as a partnership interest under paragraph (a)(1) of this section.

(g) *Effective/applicability date.* This section applies to noncompensatory options issued on or after February 5, 2013.

[T.D. 9612, 78 FR 8013, Feb. 5, 2013, as amended at 78 FR 17869, Mar. 25, 2013]

EFFECTIVE DATE FOR SUBCHAPTER K,
CHAPTER 1 OF THE CODE

§ 1.771-1 Effective date.

(a) *General rule.* Except as provided in paragraph (b) or (c) of this section, the provisions of subchapter K, chapter 1 of the Code, shall apply to any taxable year of a partnership beginning after December 31, 1954, and to any part of a partner's taxable year falling within such partnership taxable year. The provisions of the Internal Revenue Code of 1939 relating to partnerships shall apply to any taxable year of a partnership beginning before January 1, 1955, and to any part of a partner's taxable year falling within such partnership taxable year. If a partnership and the partners are on different taxable years, subchapter K shall become effective at the same time both for the partnership and for the partners.